IN THE

Supreme Court of the United States

OCTOBER TERM, 1945

No. 36

THE JOHN KELLEY COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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To attempt to answer all of the arguments advanced by the Commissioner of Internal Revenue in his brief would be to argue the case again in the same manner that the argument was originally presented to the Tax Court. This Court has clearly announced that this may not be done. In the case of *W. G. Choate* v. *Commissioner*, 324 U. S. 1, this Court said:

> "In the second place, the Tax Court found that the parties intended a cash sale of the equipment. That question is argued here as if it were open for redetermination by us. It is not. It is the kind of issue reserved

for the Tax Court under *Dobson* v. *Commissioner*, 320 U. S. 489, and *Wilmington Company* v. *Helvering*, 316 U. S. 164, 167-168."

In view of the above admonition by this Court, the Petitioner shall not file the type of reply that would be in order if the case were now being argued before the Tax Court, but it shall confine itself to a discussion of the outstanding erroneous conclusions which the Respondent reaches in his brief.

At Page 31 of his brief, the Respondent argues that because the payment of interest on the bonds is conditioned upon the "net income" of the company being sufficient during any interest period to make the payment, the board of directors could deprive the bondholders of their interest by using the earnings of the company for plant expansion. Anyone who is as familiar with income taxes as is the Respondent, certainly knows that an investment in capital assets for the expansion of the business has no bearing on the determination of annual "net income." Under the terms of the debenture in this case, if the Petitioner has annual net income as determined in accordance with usual accounting principles, it has to pay the interest on the bonds and the directors of the corporation could not refuse to make the payment on the basis that the funds were to be invested in plant expansion.

In criticizing the decision of the Tax Court, the Respondent at Page 37 of his brief states that while the Tax Court listed the determining factors to be taken into consideration in a case of this type, "it did not indicate the weight to be ascribed to any factor." The findings of fact of the Tax Court (R. 33-39) show that the Tax Court took into consideration all of the facts which the Respondent contends are the ones that make the instrument a preferred stock, and after taking into consideration all of these facts, the Tax Court found that the instrument created the relationship of debtor and creditor. By so doing, the Tax Court performed its full duty in "weighing the evidence and choosing from

among conflicting factual inferences and conclusions those which it considered most reasonable." *Commissioner* v. *Scottish American Investment Company, Ltd.*, 323 U. S. 119. And in the Scottish American Investment Company case, this Court further said that after the Tax Court carries out this duty, "the Circuit Court of Appeals has no power to change or add to those findings of fact, or to reweigh the evidence." This is exactly what the Circuit Court of Appeals did in the instant case. It determined a transaction to be "all a matter of accounting hocus-pocus" in the face of a finding by the Tax Court that the transaction was bona fide and created the relationship of debtor and creditor. If this is not the changing of a finding of fact made by the Tax Court, then the Petitioner does not know what a finding of fact is. Furthermore, who ever heard of a legal principle which requires that the Tax Court in weighing the evidence and choosing from among conflicting factual inferences the conclusion which it considers most reasonable, must announce the percentage of the total weight which it gave to each of the various factors from which it drew its final conclusion? The Respondent does not, and cannot, cite any authority to support his argument that it is the duty of the Tax Court to follow such a procedure.

At Page 45 of his brief, the Respondent states that "the case is not one for the weighing of evidence and the resolution of testimonial differences, in which the Court below would have been bound by the facts as the Tax Court found them, but one for determination of the legal effect of the language, as contained in the uncontroverted agreements in writing." If the Respondent is relying solely on the language of the debenture at R. 17 and the trust indenture at R. 19, then he cannot hope to prevail for the reason that these instruments follow the general form of the bond and the trust indenture that is adopted in any case where a corporation issues debentures. But in other parts of his brief, the Respondent argues the collateral facts, and when he does so, he diverts from any legal principle that would

govern the case and causes the case to be one in which the ultimate conclusion is a question of fact.

At Page 49 of his brief, the Respondent makes the following statement: "The principle of the law involved is the meaning of the Statute, and to hold that the contract here constitutes an indebtedness will materially alter and expand in general the meaning of 'indebtedness' in the law." The Respondent makes this statement in the face of innumerable decisions holding that each case of this type "stands on its own feet." The Circuit Court of Appeals recognized this very principle when it said in its opinion, "each case stands on its own feet" (R. 56). Since no other case can "stand on the feet of this case," it naturally follows that a decision in favor of the Petitioner is not going to "materially alter and expand in general the meaning of 'indebtedness' in the law." As a matter of fact, it will not change the Statutory meaning of the word one iota.

The Respondent attempts to avoid the application of the principle of the *Dobson* and related cases by contending that a law question is presented, rather than an ultimate conclusion of fact to be drawn from the facts as found by the Tax Court. At Paragraph 13,004, et seq., of Prentice-Hall Federal Tax Service, there are listed the various cases that have been decided concerning the question as to whether a given instrument is a bond or a preferred stock. There are some sixty-five cases listed that have been decided by the Tax Court and the Circuit Courts of Appeals. If the theory of the Government in this case is correct, namely, that it presents a question of law, then the decided cases have established some sixty-five separate principles of law; yet, none of these sixty-five legal principles would be decisive of any future case, since all of the decided cases recognize the well established principle that each case of this type stands on its own feet. And because of this fact, the very legal principle for which the Respondent is contending should cause him to lose this case because of the further principle which this Court announced in the case of *Commissioner* v. *Scot-*

tish American Investment Company, Ltd., 323 U. S. 119, namely, that where a case does not establish a precedent that will govern other cases of the same general type, then the decision of the Tax Court in a particular case is final.

The Commissioner further argues that there is a question of law involved because the case turns on the meaning of the words "indebtedness" and "interest" as used in Section 23 (b) of the Code and Regulations. Neither the word "interest" nor the word "indebtedness" is defined in the Internal Revenue Code. The Regulations merely state that, "Interest paid or accrued within the year on indebtedness may be deducted from gross income" (Respondent's Brief, Page 3). The Regulations then state that, "So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income." The Petitioner heartily agrees with this statement. It is not arguing about the definition of the word "interest" or the word "indebtedness," since the meaning of these words in the business world and in the legal field is too well known to permit of any argument. The question in this case does not concern the meaning of the word "interest" or the word "indebtedness" as used in the law and the Regulations. The real question is whether, in the light of all of the facts, the relationship of debtor and creditor was created, and in the determination of this question, "the real intention of the parties is to be sought." *Commissioner* v. *Proctor Shop, Inc.*, 82 F. (2d) 792; *Commissioner v. Palmer, Stacy-Merrill, Inc.*, 111 F. (2d) 809; *Commissioner* v. *Richmond, Fredericksburg & Potomac R. R. Co.*, 90 F. (2d) 971; *Washmont Corporation* v. *Hendricksen*, 137 F. (2d) 306; and *John Wanamaker Philadelphia* v. *Commissioner*, 139 F. (2d) 644. The intention of the parties is a question of fact and not a question of law, and, therefore, the decision of the Tax Court in a case of this kind is final. It is because of this that the case of *Bingham's Trust* v. *Commissioner*, 325 U. S. —, 65 S. Ct. 1232, referred to by the Respondent at Pages 45 and 47 of his brief, does not apply. In the Bingham case,

there was involved a question of Statutory construction, whereas in the instant case, the application or the non-application of the Statute is automatic, once the basic question is decided, namely, was the relationship of debtor and creditor created.

At Page 50 of the Respondent's Brief, he discusses the case of *Deputy* v. *DuPont*, 308 U. S. 488. This case has no bearing on the instant case. In the DuPont case, this Court held that the amounts paid by DuPont which were equal to the dividends paid on stock with respect to which DuPont was "short" were not interest payments, for the reason that the basic facts of the case did not create the relationship of debtor and creditor between DuPont and the party to whom he was required to make the payments. But in the instant case, the Tax Court held that the debentures created the relationship of debtor and creditor, from which it follows that the amounts paid in connection with the instrument were interest payments.

The same thing holds true with respect to the case of *Equitable Society* v. *Commissioner*, 321 U. S. 560, discussed by the Respondent in his brief at Page 51. In that case, this Court pointed out that the stipulation filed by the parties was insufficient upon which to base a finding as to whether the relationship of debtor and creditor existed. This Court said that the findings of fact by the Tax Court did not go beyond the stipulation, "and it apparently was not asked to go further." This Court pointed out that "appropriate findings of fact might well bring such payments within the meaning of interest, as, for example, a finding that their declaration was the basis on which new contractual engagements were made." In the instant case, the Tax Court made the proper finding. It found that the debenture created the relationship of debtor and creditor, from which it naturally follows that the amounts paid as a result of this relationship were interest payments. The Respondent cannot cite any authority which holds that if the relationship of debtor and creditor exists, then the amounts paid because of that

relationship are anything other than interest. The Circuit Court of Appeals for the Fifth Circuit clearly stated the rule in the case of *Commissioner* v. *T. R. Miller Mill Co.*, 102 F. (2d) 599, wherein the Court said:

> "'There is no comprehensive rule by which the question of deductibility may be decided in all cases. Whether the payments involved represent interest on indebtedness *depends upon the relationship of the parties*. The fundamental consideration is whether the arrangement under which the taxpayer paid $30,000 each year to the trustees gave rise to the relationship of debtor and creditor. Commissioner of Internal Revenue v. Proctor Shop, Inc., 9th Cir., 82 F. (2d) 792." (Italics supplied.)

If we eliminate from the decision of the Circuit Court of Appeals all of the references concerning the bona fides of the transaction there is nothing left. At the bottom of Page 56 of the Record, the Circuit Court of Appeals referred to the fact that the officers of the corporation and the trustees under the trust instrument were the same persons, and it then said: "It was all a little arrangement between them. The same people represented both sides of the transaction. This is enough to inspire hesitation in calling it a bona fide trust agreement." The Court readily admitted that it intended to view the case from the standpoint of the bona fides of the transaction.

In the last paragraph at R. 56, and in the first paragraph at R. 57, the Circuit Court of Appeals refers to the transaction as a "scheme." At R. 58, the Circuit Court of Appeals said that while the name given to the document is not controlling, it may be persuasive if consistently used, "as indicative of the intent and purpose of the corporation issuing the document," but that if there has been inconsistent use of such name, "it may be considered in determining whether the corporation did what it professed to do." These statements clearly show that the Circuit Court of Appeals decided for itself what the *intent* of the parties was, regardless of the finding of the Tax Court on this point, and regard-

less of the admonitions of this Court in the *Dobson* case and the Scottish American case, both of which cases had been decided by this Court prior to the release of the opinion of the Circuit Court of Appeals in the instant case. We then come to the piece de resistance of the decision of the Circuit Court of Appeals. At Page 59 of the Record, the Circuit Court of Appeals said:

> "In short, it was all a matter of accounting hocus-pocus, guided by a little too clever legal planning which eventuated in a rather flimsy scheme to avoid payment of taxes. As far as we are concerned, it will not succeed."

In other words, the Circuit Court of Appeals, in effect, said that they did not care what this Court had said in the Dobson case and the Scottish American Investment Company case, nor did they care what finding the Tax Court made concerning the intent of the parties and the bona fides of the transaction; they were going to reweigh the evidence and draw therefrom their own conclusion of fact, namely, that the transaction was not bona fide, but was all a matter of accounting hocus-pocus. Webster, in his dictionary, defines "hocus-pocus" to mean: "A juggler's trick, sleight of hand, a cheat; hence, nonsense intended to cloak deception." The Tax Court had held that the transaction was bona fide, and that it created the relationship of debtor and creditor, but the Circuit Court of Appeals, by stating that it was all a matter of accounting hocus-pocus, held that it was a mere matter of sleight of hand; that by the transaction, the parties branded themselves as cheats and that it was all a matter of nonsense intended to cloak deception. The Petitioner submits that this was the purest kind of fact finding on the part of the Circuit Court of Appeals, and that since this finding is the direct opposite of the finding of the Tax Court, it must be rejected.

The brief of the Respondent is the type of brief that the Government filed when this case was pending in the Tax

Court. Its brief argues the case as though the ultimate question of fact is still in dispute before this Court. As the Petitioner has already pointed out, the decision of this Court in the case of *W. G. Choate* v. *Commissioner*, 324 U. S. 1, clearly shows that this question may not be argued before this Court. Although the brief of the Respondent is fifty-five pages long, it fails completely to comment on the point that is absolutely decisive of this case. At Page 10 of the original brief of the Petitioner, reference is made to the statement made by this Court in the case of *Commissioner* v. *Scottish American Investment Company, Ltd.*, 323 U. S. 119, in which this Court said that where a case is of the type that it "is of little value as precedent," then the decision of the Tax Court, for that reason alone, is final, and may not be reviewed by a Circuit Court of Appeals. At R. 56, the Circuit Court of Appeals, in speaking of the type of case with which we are now dealing, said: "Each case stands on its own feet." It is an utter impossibility to reconcile this statement by the Circuit Court of Appeals with the statement made by this Court in the Scottish American Investment Company case, and undoubtedly, it was because of this impossibility that the Respondent failed to make any attempt whatever to reconcile the statements. By admitting that the case "stands on its own feet," the Circuit Court of Appeals also admitted that the case cannot be used as a precedent in deciding other cases, with the result that this case falls squarely within the language which this Court used in the Scottish American Investment Company case.

WHEREFORE, it is submitted that the decision of the Circuit Court of Appeals should be reversed.

Respectfully submitted,

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